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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

No. 244.

DEWEY SCHMOLL, Successor Assignee For Benefit of Creditors of Murch Bros. Construction Co., and NATIONAL SURETY CORPORATION, *Petitioners,*

v.

THE UNITED STATES.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI ON BEHALF OF ASSOCIATION OF CASUALTY AND SURETY EXECUTIVES, AMICUS CURIAE.

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INTRODUCTION.

This brief is filed on behalf of the Association of Casualty and Surety Executives, an association composed of sixty-six member corporations of which fifty-five engage in the business of becoming sureties. Fifty-four of these members are qualified to become sureties on bonds accepted by the United States and compose the majority of the ninety-six corporate sureties whose bonds are acceptable to the United States according to the semi-annual statement of the Treasury Department issued April 29, 1946.

PURPOSE OF THE BRIEF.

It is the purpose of the brief to draw attention to the importance of obtaining an authoritative decision upon the question presented in this litigation and especially the application of Section 3466 of the Revised Statutes, 31 U. S. C. A. 191, Act of March 3, 1797, Ch. 20, P. 5, 1 Stat. 515, 9 F. C. A., Title 31 P. 191 to the facts here disclosed. Increasingly numerous contests, some of which are now in the General Accounting Office and some in the Court of Claims, are arising between the United States and sureties whose bonds they hold with respect to the making of set-offs by the former out of contract balances which would otherwise be available to the sureties for their exoneration and indemnity. The question is one which has not, but should be decided by this Court.

The decision of the court below is in conflict with all of those cases in the Circuit Courts of Appeal, illustrated by *Philadelphia National Bank* v. *McKinlay,* 72 F. (2d) 89, 63 App. D. C. 296 (1934) and *Morgenthau* v. *Fidelity & Deposit Co.,* 94 F. (2d) 632, 68 App. D. C. 163 (1937) in which it has been held that the United States hold the unexpended contract balance as an earmarked fund for the benefit of the furnishers of labor and material to the exclusion of all creditors of the contractor. The decision of the Court below permits the invasion of this fund by the United States for the satisfaction of its collateral claims which have no relation to the trust. It is in conflict with the decision of this Court in *Henningsen* v. *United States Fidelity & Guaranty Co.,* 208 U. S. 404 (1908) to the extent that it denies the surety's right of subrogation in favor of independent claims of the United States as a creditor of the contractor and to the extent that it treats the funds in the hands of the United States as assets of the contractor notwithstanding his default in the performance of the work and his failure to pay labor and material claims.

The Comptroller General and the General Accounting Office have taken the position that the United States may

maintain the right of set-off in every case without regard to whether or not the surety has sustained a loss under its bond by reason of having completed the work or paid labor and material bills. The Court of Claims has denied the right of set-off in such cases when there was no proof of formal insolvency of the contractor. But in the case at bar, although the surety had sustained a loss by reason of having been required to pay labor and material bills, the claim of the United States to the right of set-off was allowed by the Court of Claims because it appeared that the contractor had made an assignment for the benefit of creditors. The Court, however, in allowing such set-off stated specifically that it was not deciding whether or not the same ruling would apply to a surety on a performance bond, or in other words, to a situation where the surety had sustained its loss as a result of having completed the work.

The General Accounting Office has declined to be guided by the principles laid down by the Court of Claims and has taken the position that it will continue to make the set-offs in the absence of an authoritative decision by this Court with respect to the precise question involved. It has disregarded the principles of the Henningsen case, supra, as well as decisions of the lower Federal courts. As a consequence, the subject is in confusion.[1]

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[1] The General Accounting Office follows the practice of setting off independent claims against contract balances regardless of whether the surety completed the work, *U. S. Fidelity & Guaranty Co.* v. *United States,* 92 C. Cls. 144, 148-149 (1940), or whether it had paid material bills, *Maryland Casualty Company* v. *United States,* 100 C. Cls. 513, 516 (1944). Subsequent to those decisions the Comptroller General ruled on July 14, 1944, in decision No. B-17988 (not officially reported) that:

> "Accordingly, and in the absence of a contrary ruling by the Supreme Court of the United States, the Maryland case may not be accepted to change or modify the long standing view of this office that the right of the United States to have its debts first satisfied from funds earned by a contractor is paramount to the right of a surety asserting a loss in making pay-

SUMMARY OF FACTS.

Between 1933 and 1935 the United States entered into over 17 contracts with Murch Brothers Company, Inc., a contractor, for the construction or remodelling of various post office buildings (R. 32-33). In pursuance of the provisions of the Act of August 13, 1894, C. 280, 28 Stat. 278; Feb. 24, 1905, C. 778, 33 Stat. 811; Mar. 3, 1911, C. 231, ¶291, 36 Stat. 1167, 40 U. S. C. A. 270 the National Surety Corporation became surety upon bonds[2] of the contractor given to the United States to secure the payment of labor

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ment of the claims of materialmen and laborers, and the action heretofore taken in the matter must be, and is, affirmed."

The same policy was again reiterated on April 18, 1946, when it was said:

> "What was said in the above-quoted decisions relative to the decisions of the Court of Claims is especially appropriate to the present matter of the holding of that court in the *Maryland Casualty Company case.* And while careful consideration has been given to the matters advanced by you in support of the contention that this office should regard the ruling in that case as a controlling precedent in the settlement of the instant claim, it must be concluded, in the absence of an authoritative decision by the Supreme Court of the United States with respect to the precise question involved, that the *Maryland Casualty Company case* may not be accepted to change or modify the long standing view of this office that the right of the United States to have its debts first satisfied from funds earned by a defaulting contractor is paramount to the right of a surety asserting a loss in completing the defaulted contract." B-41334 (Not officially reported).

In re Van Winkle, 49 Fed. Supp. 711 (D. C. Ky.-1943) and *American Surety Co. of New York* v. *City of Louisville M. H. Comm.*, 63 Fed. Supp. 486 (D. C. Ky.-1945) both hold the surety's right to such funds to be superior to claims of the United States.

[2] The bonds given here join in a single instrument the dual obligation that the contract be performed and payment be made for labor and material. A subsequent enactment, Act of August 24, 1935 C. 642 pp. 1-4, 49 Stat. 793-4, 40 U. S. C. A. 270 a-d. provides for two bonds, one guaranteeing performance of the contract and the other payment for labor and material. The changes effected were designed to eliminate procedural difficulties which had arisen under the earlier Act. The substance of the law remains unchanged.

and material furnishers and the performance of the work under 17 of these contracts (R. 34).

By June of 1935 the contractor had performed a large part of the work required under its contracts; but during that month, because of lack of funds and its inability to secure more, it became unable either to pay for labor and material which had been furnished it, or to complete the work. Thereupon the United States terminated the contractor's right to proceed with the work remaining to be done and proceeded to have it completed (R. 34-35). In some instances the cost of completion was less than the unpaid balance of the original contracts, while in other instances such cost exceeded the unpaid balances (R. 35-36).

Subsequent to the termination of the contractor's right to proceed with the work, persons who had furnished labor and material for use under various of the 17 contracts made claim upon the surety for payment therefor as required by the latter's bonds. The surety responded by making payments to such labor and material-men in the total amount of $202,011.66. In every instance where the total cost of completion was less than the contract balance which remained at the time of the contractor's default, the surety paid labor and material claims appreciably exceeding the surplus thus established (R. 38-46).

In all instances where the cost of completion by the United States exceeded the unexpended contract balances, thus raising charges against the contractor and its surety, those charges were satisfied by setting them off against the surplus monies remaining under the contracts which were completed by the United States for less than the balances on hand (R. 47-48). But after these charges were satisfied, there still remained in the hands of the United States a balance of $22,505.01 allocable to contracts (R. 47-48) in connection with which the surety had paid labor and material bills to the extent of $100,444.17 (R. 38, 39, 40, 41, 42-43).

The United States had assessed a capital stock tax against the contractor for the year 1935 in the amount of $206.53 (R.

47). Under two other contracts entered into between Veterans Administration and the contractor, charges for defective work had accumulated against the contractor in the amount of $2,552.43. With these contracts the surety had no connection whatsoever. (R. 46-47) The General Accounting Office undertook to set off these unrelated items against the balances allocable to contracts which the surety had bonded and on account of which it had been obliged to make payments (R. 46-47). The Court below, while awarding the remaining balance to the surety, upheld the off-set of these unrelated items against the contract balances (R. 66-69). The right of the United States to off-set these two unrelated and collateral items is the subject of the controversy here sought to be settled and clarified.

The contractor executed an assignment for the benefit of its creditors pursuant to which the original plaintiff in the court below was appointed assignee on January 3, 1936 (R. 32), or approximately six months after default had resulted in termination of the various contracts upon which the surety was obligated (R. 34).

ARGUMENT.

The Surety's Rights Are Contractual.

The failure of the contractor to pay its bills for labor and material constituted a breach of contract. In *Martin* v. *National Surety Company*, 300 U. S. 588 (1937), it was said that:

> "* * * the statute directs that a bond for the prompt payment of materialmen and laborers shall be executed by the contractor before the commencement of the work. Not only that, but the contract with the Government, which was drawn in the standard form, is a confirmation and adoption of the statutory duty. The terms of the bond are read into the contract, and there is default under the contract when there is default under the bond."

As a consequence of this default, as well as the contractor's failure to continue with the work, it forfeited its rights to receive payment under the several contracts. It is certain that neither the contractor nor his assignee was entitled to maintain any claim to the contract proceeds before the work was complete; and similarly, until the labor and material claims were paid, the contractor and his assignee remain in the same position, *Philadelphia National Bank* v. *McKinlay, supra.* The contract balances were used for the completion of the work and they should be equally available for the payment of labor and material bills. The surety, which has only a secondary liability for both completion and payment of labor and material bills, is entitled to insist upon the use of the contract balances to remedy both defaults under the contract. There is neither reason nor logic in allowing the balances to be used for the repair of one default and diverting them from the payment of the other default. If the decision of the Court below is correct, it would be equally logical to require that the surety complete the work as well as pay labor and material bills, while the United States absorbed the entire unexpended contract balance in liquidation of independent claims which they held against the contractor.

Since the failure to pay labor and materialmen constituted a breach of the contract, the United States had the right to withhold contract payments until the breach was remedied. The United States did, in fact, withhold payment of the contract balances after the time of the contractor's default. Under these circumstances the diversion of the contract payments to the satisfaction of other debts of the United States would amount to a departure from the contract terms which in itself might release the surety from the obligation of its bonds. The surety does not ask to be released; it has met the obligations of its bonds. It has insisted that there be adherence to the original terms of the contract and that the United States recognize its right to reimbursement for

its losses—a right which accrued to it as a consequence of its entering into the transaction.

That the diversion of the contract funds amounts to a breach of the contract is further demonstrated by the rule which releases the surety where the party secured makes a material departure from the terms of the contract, the performance of which the surety bonded. It is inescapable in the present instance that the true intendment of the parties was that the contract price should pay for the completed building and all the labor and material in it. This is further emphasized by the provision for payment as the work progressed (R. 19) which was obviously designed to enable the contractor to pay such bills during the course of the work.

The surety is entitled to stand upon the precise terms of its contract.

> "Nothing can be clearer, both upon principle and authority, than the doctrine that the liability of a surety is not to be extended, by implication, beyond the terms of his contract. To the extent, and in the manner, and under the circumstances pointed out in his obligation, he is bound, and no farther. It is not sufficient that he may sustain no injury by a change in the contract, or that it may even be for his benefit. He has a right to stand upon the very terms of his contract; and if he does not assent to any variation of it, and a variation is made, it is fatal." Per Mr. Justice Story, *Miller* v. *Stewart*, 9 Wheat. 680.

The practical effect of what has been done by the Court below is that the surety is required to pay the unrelated charges for taxes and defective work out of funds which the whole transaction intended should be for its benefit. The Court of Claims recognized the absurdity of this result when it said with reference to the surety in *Maryland Casualty Co.* v. *U. S.*, 100 C. Cls. 513, 521:

> "But we do not think that it intends, or is expected by the Government or the other contracting party to take the risk that any part, or perhaps the whole, of the contract price which by the contract the Government

promises to pay upon performance, will be "paid", not in money but by a bookkeeping process of crediting these sums against taxes or other debts of the contractor not related to the contract, to the prejudice of the surety."

Equity Recognizes and Enforces an Ownership of the Fund in Favor of the Surety.

In *Henningsen* v. *United States Fidelity & Guaranty Co.*, 208 U. S. 404 (1908) the contractor had completed the building but failed to pay labor and material furnishers. The latter were paid by the surety pursuant to the bond given under the same statute as here. Thereupon a contest ensued between the surety and the contractor's assignee for the balance of the contract price. This Court held that the surety was entitled to subrogation and as a consequence to be reimbursed for the payments which it had made. It was said:

> "The guaranty company was surety on that contract. Its stipulation was not merely that the contractor should construct the buildings, but that he should pay promptly and in full all persons supplying labor and material in the prosecution of the work contracted for. He did not make this payment, and the guaranty company, as surety, was compelled to and did make the payment. Is its equity superior to that of one who simply loaned money to the contractor, to be by him used as he saw fit, either in the performance of his building contract or in any other way? We think it is. It paid the laborers and materialmen, and thus released the contractor from his obligations to them, and to the same extent released the government from all equitable obligations to see that the laborers and supplymen were paid. It did this not as a volunteer, but by reason of contract obligations entered into before the commencement of the work."

The application of this doctrine to construction contracts of the United States stems from *Prairie State National Bank* v. *United States*, 164 U. S. 227 (1896). There the con-

tractor defaulted and the surety completed the work. It was held that the surety was entitled to subrogation to the rights of the United States and that its subrogation must be considered as arising from and relating back to the date of the original contract. It was held that the surety became entitled to resort to the securities and remedies which the United States were capable of asserting against the contractor and that one of such remedies was the right, based upon the original contract, to appropriate the monies retained for the reduction of the damage. This Court said at page 233:

> "That a stipulation in a building contract for the retention, until the completion of the work, of a certain portion of the consideration, is as much for the indemnity of him who may be guarantor of the performance of the work as for him for whom the work is to be performed; that it raises an equity in the surety in the fund to be created; and that a disregard of such stipulation by the voluntary act of the creditor operates to release the sureties, is amply sustained by authority."

In *Belknap Hardware Mfg. Co.* v. *Ohio River, Etc. Company*, 271 Fed. 144 (C. C. A. 6th—1921) it was said with reference to *Henningsen* v. *United States Fidelity & Guaranty Co., supra:*

> "Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think the necessary effect of the decision is to hold that the laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated. This is not stated in the opinion in very express terms, but it had been pressed upon the court (208 U. S. 407, 408, 28 Sup. Ct. 389, 52 L. Ed. 547) that there could be no such subrogation without such a right, and that there was no such right. On page 410, of 208 U. S., on page 391 of 28 Sup. Ct. (52 L. Ed. 547), the court refers to and assumes that the Government, after the bond was given was still charged with 'equitable obligations to see that

the laborers and supply men were paid.' We are constrained to think that the decision necessarily rests upon the existence of this right, as one entitling these claimants to priority in payment out of the fund, and therefore as entitling the surety, as their equitable assignee by subrogation, to the same priority."

See also:

Hardaway v. *National Surety Co.*, 211 U. S. 552 (1909)
In re Scofield Co., 215 Fed. 45 (C. C. A. 2d—1914)
American Bonding Co. v. *Central Trust Co.*, 240 Fed. 400 (C. C. A. 7th—1917)

In another instance where a surety sought to recover from a bank the proceeds of a contract entered into by a contractor, Anderson, and the United States, the court said:

"Thus, in consequence of Anderson's default, the $37,170.04 then in the hands of the United States became a fund which the United States was entitled to apply to the payment of materialmen's claims, and which appellee, as subrogee of the United States, was entitled to have applied in reimbursement of the $21,609.28 expended by it in paying such claims; and appellee's right to have the fund so applied was superior to any right of Anderson or Anderson's assignees—if any." *California Bank* v. *U. S. F. & G. Co.*, 129 F. (2d) 751 (C. C. A. 9th—1942).

The general rule on this subject is stated in *Hayes* v. *Ward*, 4 Johns. Ch. (N. Y.) 123 by Chancellor Kent to be:

"* * * a surety will be entitled to every remedy which the creditor has against the principal debtor, to enforce every security, and to stand in place of the creditor and to have his securities transferred to him, and to avail himself of those securities against the debtor."

The Court below has recognized the application of this proposition in *United States Fidelity & Guaranty Co.* v. *United States*, 92 C. Cls. 144 (1940) and in *Maryland Casu-*

alty Company v. *United States*, 100 C. Cls. 513 (1
well as that enunciated in *Henningsen* v. *United St*
delity & Guaranty Company, supra, but has conclu
the insolvency of the contractor within the meaning
3466 compels a different result.

As early as 1898 the courts had viewed the claims
nishers of labor and material as having the pos
special liens:

> "The practical effect of the statute is to
> special lien in favor of such persons and to s
> this bond, in the place of the public building
> thing upon which that lien is charged." *Mar*
> *pany* v. *Burgdorf*, 13 App. D. C. 506, 519 (189

The same court subsequently, in *Richards Bric*
Rothwell, 18 App. D. C. 516, 537 (1901) said:

> "There is, therefore, by necessary implica
> equitable lien and preference secured in favo
> parties who furnish labor and materials in th
> tion of the contract, in the application or distri
> the contract price remaining to be paid; an
> the government, as in the present instance, ho
> hands any part of the money contracted to be
> the work, and there remain unpaid claims for la
> materials supplied, it holds such fund as quas
> for the benefit of those entitled to receive it u
> condition in the bond; that is so say, the labo
> materialmen remaining unpaid. This right ter
> ence being the result of the operation of the stat
> the condition of the bond, it is the clear right, h
> plainest principles of justice, of the sureties in
> to invoke a court of equity to enforce the pro
> and equitable lien for their protection. In con
> this act of Congress of 13th August, 1894, thi
> said, in the case of *Marble Company* v. *Burg*
> App. D. C. 506, 519 (1898):
>
> > 'The practical effect of the statute is to
> > special lien in favor of such persons (parties
> > ing labor and materials) and to substitute

in the place of the public building, as the thing upon which that lien is charged.'

"That is to say, the bond is liable rather than the building upon which labor and materials are used in construction; and if the sureties should pay claims for such labor and materials for which they may be responsible on the bond, they have a right, upon well-settled principles, of substitution to such claims as against the contract price of the work remaining due to the contractor. And having such right of substitution, the sureties have a right to interpose to prevent the diversion or misapplication of the fund, and to require it to be paid out to the parties entitled to receive it in the first instance by virtue of the lien and preference given by operation of the statute."

The Surety's Rights Are Not Affected by R. S. 3466.

R. S. 3466 accords the United States no more than a priority in the assets of the debtor. R. S. 3466 does not give the United States priority in assets which do not belong to its debtor. In cases where contract funds were in the hands of the owner, and impressed with the rights of the surety who had paid labor and material claims, the surety's rights have been recognized as paramount to those of the contractor, and as a consequence as paramount to claims of the United States against the contractor. This has been done on the stated notion that the rights of the United States could rise no higher than the rights of its debtor.

United States Fidelity & Guaranty Co. v. *Triborough Bridge Authority*, 48 N. Y. S. (2d) 16 (1944)
Karno-Smith Co. v. *Maloney*, 112 F. (2d) 690 (C. C. A. 3d—1940)
F. H. McGraw Co. v. *Sherman Plastering Co., Inc.*, 60 F. Supp. 504 (D. C. Conn.—1943)
See also *In re Heintzelman*, 34 F. Supp. 109 (D. C. N. Y.—1940)

In the case at bar the principles are the same, and no difference in result is warranted by the fact that the funds are in the possession of the United States.

The cases which have dealt with the application of R. S. 3466 are cases involving the distribution of assets in some legal proceeding undertaken for that purpose. They are cases such as *United States* v. *Waddill, Holland & Flinn,* 323 U. S. 353 (1945), and *United States* v. *Emory,* 314 U. S. 423 (1941). In none of those cases has it been held that the priority accorded to the United States extended to assets as to which the interests of the debtor had been displaced and subordinated prior to the institution of the proceedings, and which were not and could not be administered in the insolvency proceedings, because the debtor, his assignee or receiver could not collect them over the claim of the surety. In none of the cases dealing with the application of R. S. 3466 has it been held that the United States may assert a claim to funds which as a consequence of its own contract with the surety are payable to the latter for the reimbursement of its expenditures either in completing the work or paying labor and material bills. Particularly should this be true where, as here, the claimed off-sets are unrelated to the bonded contracts which produced the funds involved.

The defaults under the contracts in the case at bar occurred in June, 1935 (R. 34). The rights of the surety to exoneration and subrogation came into operation at that time. Those rights relate back to the date of the original contract, *Prairie State National Bank* v. *United States,* 164 U. S. 227, 232 (1896). The incidence of the contractor's insolvency established by an assignment for the benefit of creditors six months later should not be permitted to oust the rights acquired long previously by operation of law.

CONCLUSION.

The uncertainty which now exists as to the application of R. S. 3466 to the situation in the case at bar as well as the confusion enveloping the subject generally as a consequence of the conflicting views of the General Accounting Office and the courts should be settled by a decision of this Court. The decision of the Court below is in error in sustaining a right

of set-off against the fund which both by contract and equity belongs to the surety. It is submitted that the application for the writ should be granted.

Respectfully,

ALEXANDER M. HERON,
Attorney for the Association of Casualty and Surety Executives, Amicus Curiae.